



Republican Policy Committee

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The Explosive Growth of Earned Income Tax Credit (EITC)

- The EITC is one of the fastest growing programs in the federal government. The 1994 cost of the EITC was \$21.8 billion, eclipsing the federal cost of Aid to Families with Dependent Children (AFDC). And, the program is fully indexed for inflation.
- Fraud is rampant. In 1988, the IRS found that 42 percent of EITC recipients received too large a credit and 32 percent were not able to show they were entitled to any credit.
- The maximum EITC payment (\$3,110 in 1995) is not based on the quantity of days or hours worked, and so is equally available to both a cashier who works 2,000 hours a year earning \$5.50 an hour and a part-time Washington lobbyist who works 100 hours a year earning \$100 an hour.
- The EITC is the only tax credit that yields a payment if the filer's credit exceeds his tax liability. In fact, approximately 80 percent of the benefits are direct handouts to recipients whose credit exceeds their tax liability (historically from 1975 until 1989 direct handouts made up 70 percent of EITC benefits but since 1990 the number has hovered near 80 percent).
- Given the growing generosity of the program, it should not be surprising that the number of recipients for this credit has grown from about 6 million in 1975 to 18 million today.
- And the growth spiral continues. While participants in 1993 were expected to exceed the 1990 number by only 11 percent, 1993 costs were expected to be 91 percent above the 1990 level. Recipient units are projected to be 34 percent higher in 1996 than in 1993, and costs are projected to rise by 90 percent over the three years.

The Earned Income Tax Credit (EITC) was established in 1975 to provide a rebate to low-income, full-time workers to help defray the disemployment effects of the Social Security payroll tax. However, recent expansions have made the EITC into more of a welfare program than a tax refund. In 1994, of the total federal cost of the program, only \$4.6 billion was in revenue foregone (or tax rebates), and \$17.2 billion was in grants paid. Thus, only 20 percent of the cost of the program is for actual reductions, or refunds, in the amount of taxes paid.

The EITC is a refundable federal income tax credit available to families in which a family member works and family income is less than \$24,396 in 1995 (or \$26,673 for families with more than one child). At year's end, if the EITC exceeds income tax liability, the U.S. Treasury refunds the excess to the filer.

As an example of how the formula for the credit works in 1995, families with more than one child earn 36 cents of EITC for each dollar of earnings up to \$8,640. The maximum credit of \$3,110 is available to those families with earnings between \$8,640 and \$11,290. The credit is then reduced by 21 cents for each dollar of earnings above \$11,290 until it phases out at \$26,673.

The EITC's broad availability to low-income working taxpayers may include individuals or families with high net worths but low incomes. Additionally, under current law, taxpayers who meet the income standards can qualify for the credit whether or not they have children: the Omnibus Budget Reconciliation Act of 1993 (OBRA) for the first time allowed individuals with no children to qualify. In 1987, the credit was indexed for inflation. The income thresholds necessary to qualify for the credit also have been indexed for inflation.

OBRA 1993: The Clinton Plan

The Omnibus Budget Reconciliation Act of 1993 greatly expanded the EITC. The bill increased spending for the program by \$20.9 billion over five years from FY94-FY98. Over the last four years, growth rates in the EITC have been 55 percent, 22 percent, 21 percent, and 42 percent respectively.

As noted above, in 1995, the credit is based on 36 percent of earnings up to the maximum creditable amount. When OBRA '93 is fully in effect in 1996, the credit will be 40 percent for families with more than one child, which is double what it was in 1993 (19.5 percent).

In 1993, total cost of the EITC was \$15.6 billion. Under the current system, the total cost of the EITC will be \$25.3 billion this year, \$28.4 billion in 1996 and will increase to \$36.2 billion by 2002.

GAO Report Demonstrates Need for Reform

According to the GAO, the IRS in 1998 determined that nearly 42 percent of the EITC recipients received too large a credit and nearly 32 percent were not able to show they were entitled to any credit. In that year, about \$1.9 billion, or one-third, of the total EITC paid out, was awarded erroneously.

Another study conducted by the IRS in 1994, in which electronically filed returns sent in during the first two weeks in January were scrutinized, found that approximately 29 percent of these recipients received too much EITC, and 13 percent intentionally claimed too much.²

The problem of fraud may only get worse. In 1995, a filer with more than one child can claim to have earnings of \$8,650 and be eligible for a 36 percent credit. Even while subtracting the 7.65 percent Social Security tax that would be due, the filer would net a credit worth 28.35 percent, or \$2,452. This monetary incentive to fabricate earned income will be heightened in 1996 by the last phase of the EITC expansion enacted in OBRA '93. Disproving a claim of earnings from a casual job by a low-income filer may be difficult, if not practically impossible, for the IRS to do. The Director of the IRS Criminal Investigations Operations Division, Ed Federico, was quoted as saying: "How can you prove that someone didn't work? It may be that we can't prove a negative."

One reason for the high rates of fraud is the fact that the program writes big checks. The maximum credit in 1995 is \$3,110, and while taxpayers may elect to collect their credit in equal installments throughout the year instead of in one lump sum, few chose to do so. The GAO found that less than one-half of one percent did so in 1989.

While the EITC was created to encourage individuals to work, the effect may be just the opposite. In 1988, the GAO estimated that hours worked by EITC recipients may have declined by 3.6 percent overall, and by more than 10 percent for working spouses. The GAO also found that the average EITC recipient worked only 1,300 hours, compared with a normal work year of 2,000 hours. Moreover, the maximum EITC is equally available to both a cashier who works 2,000 hours a year and earns \$5.50 an hour and a part-time lobbyist who works 100 hours a year and earns \$100 an hour.³

The GOP Proposal: No Cuts, But Slow the Rate of Growth

The EITC proposal contained in the Senate GOP budget plan is not a cut. It simply tries to rein in the irresponsible explosion in federal government spending for this program. The plan only will slow the increase in the cost to the federal government from this tax credit.

Under the Senate budget plan, the cost of the EITC will increase from \$28 billion in 1996 to \$32 billion in 2002, while current law would see EITC costs of \$36.2 billion in 2002. Over the seven-year period from 1996 to 2002, the budget proposal to reform the EITC would save the federal government \$21 billion.

	1996	1997	1998	1999	2000	2001	2002	Total
EITC Baseline (CBO)	\$28	\$30	\$31	\$32	\$34	35	36	\$226
EITC Reforms	(0)	(3)	(3)	(3)	(4)	(4)	(4)	(21)
EITC Baseline After Reforms	28	26	28	29	30	31	32	204

(Source: CBO, Senate Budget Comm. maj. staff; all numbers are in billions)

Under the reform proposal, benefits to eligible families also will continue to increase. In 2000, eligible families with one child will receive \$2,460 a year and eligible families with more than one child will receive \$3,560 a year. These same families received \$1,434 a year and \$1,511 a year respectively in 1993; this amounts to an increase of \$1,026 a year for a family with one child and an increase of \$2,049 a year for families with more than one child.

Maximum Family Credit

	1993	1996	1997	1998	1999	2000
Current Law (1 child)	\$1,434	\$2,156	\$2,227	\$2,305	\$2,383	\$2,462
Budget Reforms (1 child)	\$1,434	\$2,156	\$2,225	\$2,300	\$2,379	\$2,460
Current (More than 1 child)	\$1,511	\$3,564	\$3,680	\$3,804	\$3,936	\$4,068
Reforms (More than 1 child)	\$1,511	\$3,119	\$3,220	\$3,329	\$3,444	\$3,560

The reform proposal also eliminates EITC benefits for individuals without dependent children, which follows the Senate-passed version of the OBRA '93, and brings the program back to its original intention: to help families.

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1. GAO Briefing Report to the Chairman, Committee on Governmental Affairs, U.S. Senate, "Earned Income Credit: Targeting to the Working Poor," March 1995.
2. Ibid.
3. Information from GAO, "Earned Income Credit: Targeting to the Working Poor," and CRS Report for Congress, "The Earned Income Tax Credit: A Growing Form of Aid to Low-Income Workers," April 13, 1995.